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DOW THEORY LETTERS INC.

"The Market as Interpreted under the Dow Theory"

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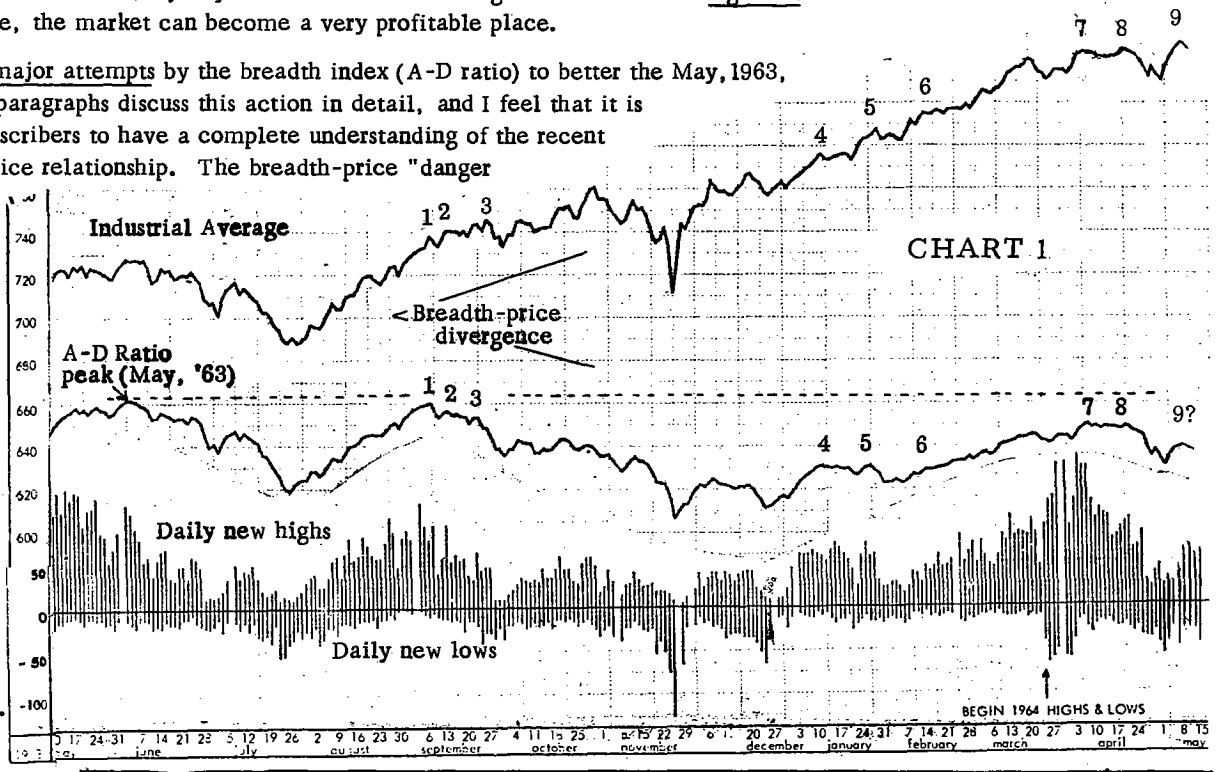
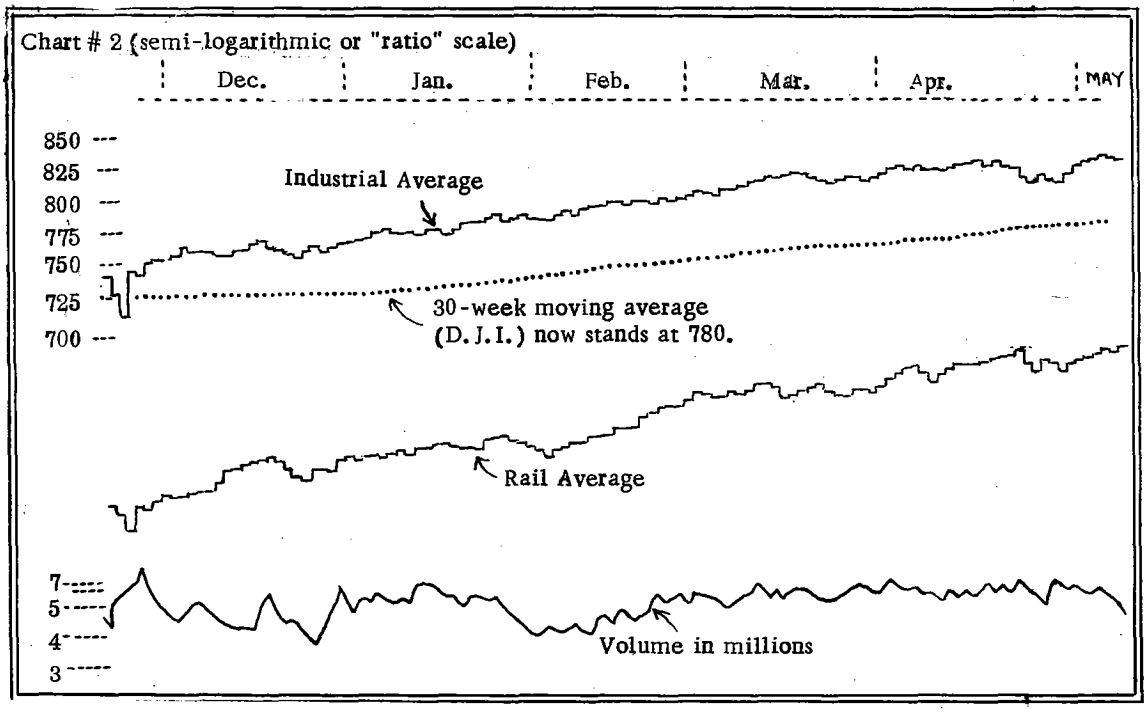
MARKET AT THE CROSSROADS: The strength of the market over the past year stems from the fact that the two Averages (Industrials and Rails) have continued to advance to new highs together (Chart 2). The frustration among stockholders and traders during the past year arises from the fact that the mass of issues, as measured by the advance-decline ratio, have never been able to better the May, 1963, peak. The consolation for patient market practitioners comes from their knowledge that sooner or later the majority of stocks and the Averages will rise or fall together. When such movements materialize, the market can become a very profitable place.

There have been two major attempts by the breadth index (A-D ratio) to better the May, 1963, high. The following paragraphs discuss this action in detail, and I feel that it is most important for subscribers to have a complete understanding of the recent and current breadth-price relationship. The breadth-price "danger signals" are reviewed on Chart 3 for the benefit of new subscribers.



As shown on Chart 1, the first assault on the May, 1963, A-D ratio peak occurred during September, 1963. On September 6 the Industrial Average recorded an historic high, and the A-D ratio (point 1) touched its highest level since May, 1963. Unfortunately, Industrials and breadth then parted company, and a full breadth-price divergence (points 1, 2, 3) materialized. The downside action ended at the "assassination lows".

A new advance began, and on January 9, 1964 (peak 4 on chart), the A-D ratio again established a temporary peak. A series of higher Industrial closings (point 5 and 6) occurred against a series of declining breadth peaks (5 and 6), but this potential divergence teminated when, during February, the A-D ratio suddenly turned up and bettered its January 9 peak



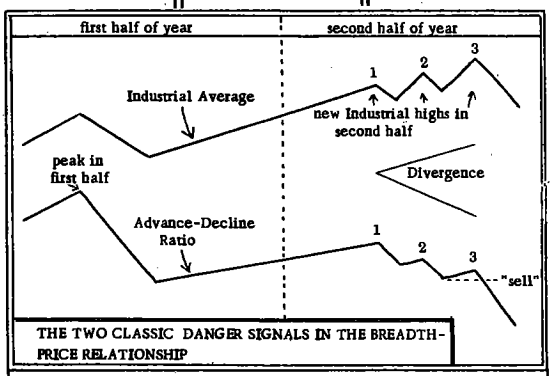
 (point 4). This was the first time that this writer has ever seen a potential breadth-price divergence erased by a renewed breadth rally above the first divergence peak (in this case peak 4).

During March and April the A-D ratio started its second broad assault on the May, 1963, breadth peak. On April 6, Industrials recorded an historic high of 820.25 while the A-D ratio (at point 7) climbed to its highest level since the assassination lows. A slight recession ensued, followed by a new rally which took Industrials to another all-time high on April 17 (827.33). The new Industrial peak, however, was not confirmed by the A-D ratio (point 8). A sharp but short decline followed.

On May 1 the latest rally got underway. On May 6, Industrials climbed to a further record high. Again the A-D ratio refused to confirm (point 9) — this time by a wide margin. All of which brings us to the present.

The big question now is: will the current (second) approach by the A-D ratio to the 1963 breadth peak end with another completed breadth-price divergence (and resultant major "sell signal"), or will breadth (as it did in February) suddenly turn up and erase the divergence by rising above the first peak (in this case, the April 6 peak at point 7 on chart)? Thus, the next important movement of the market will be forecast by the A-D ratio — either a show of strength and a rise above the April 6 peak, or a show of dangerous weakness and a decline in breadth below the April 30 low.

Chart # 3



THE TWO CLASSIC DANGER SIGNALS IN THE BREADTH-PRICE RELATIONSHIP

The first danger signal is illustrated as breadth (the A-D ratio) records its annual peak in the first half of the year while the Industrial Average goes on to establish successive (unconfirmed) highs during the second half of the year. The second danger signal is a full breadth-price divergence as signified by the successive peaks labeled 1, 2 and 3 on chart. Both indicators record highs at point 1. At 2 Industrials rise to a new high but at 2 the A-D ratio fails to better its own preceding peak at 1. The process is repeated at peak 3, following which both indicators turn down. The divergence is completed and a "sell-signal" is given when (following point 3) the A-D ratio breaks to a new low as shown on chart.

One thing is clear; the May, 1963, ceiling represents a formidable barrier for the mass of issues on the N.Y.S.E. as measured by the A-D ratio. Twice (September and now) the breadth index has pushed to the 1963 level. The September assault failed. The current test is now in the process of being resolved.

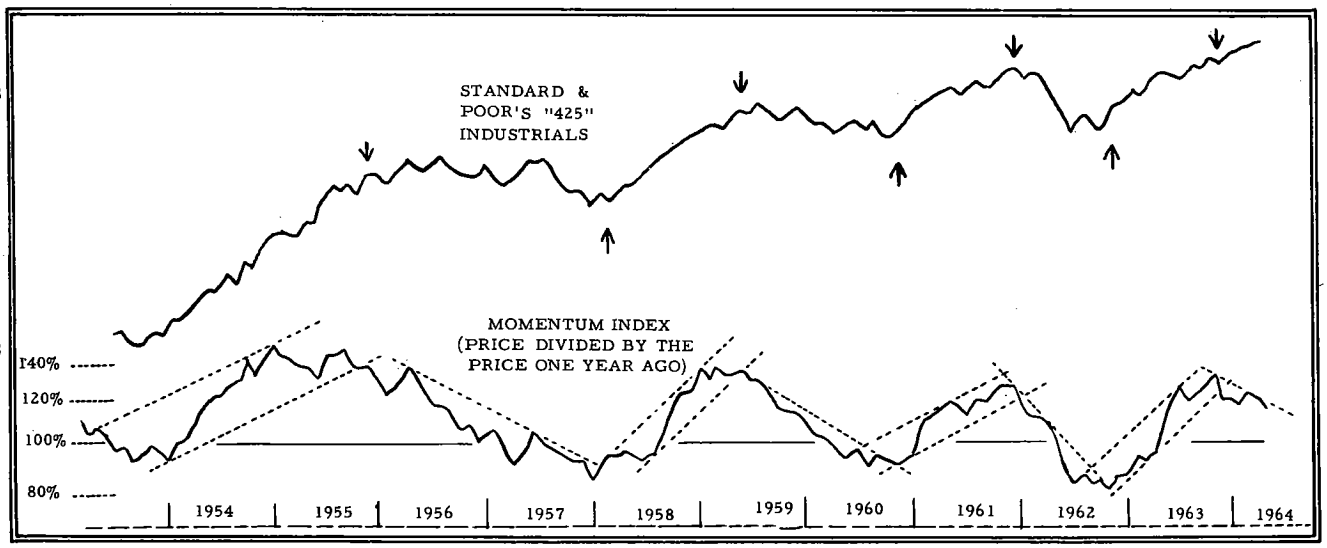
MOMENTUM: If we toss a ball into the air, it will rise rapidly at first, but with each passing second its rate of ascent will slacken. Finally, there will be a point at which the rate of climb will cease — and the ball will hang motionless in mid-air. Following this, the ball will begin its ascent back to earth. Thus the tossed ball gains upward momentum, looses it, hangs motionless, then takes on downward momentum. This same principle may be applied to the stock market.

Analysts make use of a variety of indicators with which to gauge the momentum of the market. Most of these devices are based upon changes (in percentages) of a given stock average over a specified period of time. For instance, an average may be continously compared with its own level a month ago, 200 days ago, six months ago or a year ago. One of the best of these so-called momentum indexes is the broad Standard & Poor 425 Industrial Average taken as a percentage of its own price one year ago.

Chart 3 traces eleven years of such action, and I have decided to include this chart (or offer comments about it) monthly (with each new tabulation). The chart is constructed by dividing the end-of-the-month price of the S & P 425 Industrial Average by the price of that index at the end of the corresponding month one year ago. For reference purposes, the actual monthly closings of the S & P have been superimposed on the chart above the momentum index.

Thus we see that the momentum index is simply the price of the 425 as a percentage of that Average's price one year ago. As long as the index is above 100 (it is now 116) we know that the price of the 425 is higher than it was a year ago, and the converse is true when the index is below 100.

Note that the momentum index seems to travel along fairly well defined rising or declining channels. Penetrations of these channels have provided early and quite reliable



indications of impending changes in direction of the S & P 425.

The momentum index is considered to have signalled a forthcoming change in direction when it breaks definitely above or below the prevailing channel. S & P's 425 Industrial Average has usually followed these "signals" within a few months. The history of the great "crashes" shows the following relationships: the momentum index broke down 5 months ahead of the final peak in the 425 in 1929. The index broke 5 months ahead of the 425 in 1937. But in 1946 the lead time was only 1 month. As seen on the chart, in December, 1961, the momentum index broke simultaneously with the final peak in the S & P 425.

The arrows on the graph identify points at which the momentum index broke either above or below well defined channels. All in all, the record of this index has been a good one, and it has proved its usefulness over and over again. The two most difficult (premature) signals came in 1951 and in 1955. In 1951 the index turned lazily down a full year-and-a-half ahead of the final 1953 peak in the S & P 425. In 1955, the index broke in May, 14 months ahead of the final 1956 peak in S & P's 425.

The most recent signal of change was given by the momentum index on November 29, 1963 (note down-arrow on chart). More than five months have passed since the 1963 signal. During that time the S & P 425 has pushed persistently into new high ground. Nevertheless, the momentum chart shows us the one thing it can show — the momentum of the 1962-64 advance has been ruptured. The latest tabulation (April 30, 1964) places the momentum index at 116, its lowest reading since early 1963. A definite downward channel now seems to have formed. In the past, when such declining channels have appeared, the market has been subject to an extended period of irregularity, a secondary reaction or a full bear market — prior to the next broad advance.

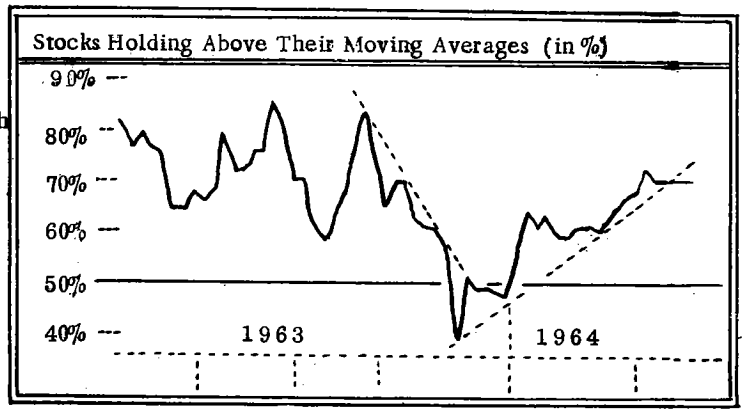
PROFITS AND LOSSES: I do not remember a time when there was more confusion, difference of opinion, change of opinion or general frustration — both amateur and professional. Typical professional examples: one old and respected investment service announced some months ago that the huge "broadening pattern" in the Industrial Average (see last Letter) was in reality a powerful "catapult formation" capable of propelling the Dow up several hundred points. For this reason, they stated, those lucky enough to be fully invested were in for a joy ride, a ride that this particular service "would not want to miss." But a week or so ago this same service turned bearish and suggested extensive selling.... Another typical case: a widely-followed service which has prided itself on being bullish since 1949 has predicted that the final post-war bull market peak is looming ahead — but it will not arrive until late 1964 or early 1965. However, they freely admit (and I agree) that many stocks have already "topped out, and they suggest that long-term investors now (at long last) embark on a definite selling program (with the purpose of "cleaning out" by late 1964). What about stocks that have already collapsed? Well, sell them on rallies.... A third nationally known service provides a monthly index — an index which has turned bearish regarding the trend of stocks and the economy for the coming months. Yet this service now hedges by saying that the tax cut will undoubtedly mitigate or even erase the bearish implications of their own statistics.

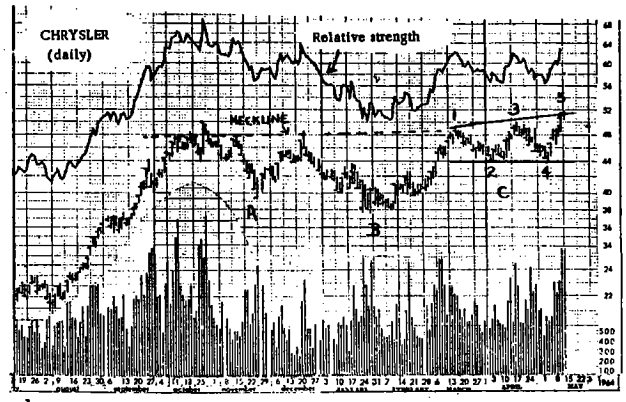
What is all the confusion about? I believe this is the answer: in a powerful bull movement the Averages and the majority of stocks will push higher throughout the major part of a bull swing. In order to make money, one must take a substantial position in a selected group of stocks. During a true bull movement, a certain number of these stocks will register substantial gains, a few will show small gains, and a few may even refuse to budge. But here is the important point — there will probably not be any major losses; there will not be a collapse or a decline for every important rise. In other words, breadth will move up with the Averages. Such a situation is, of course, conducive to producing large profits.

Unfortunately, this type of action has not been part of the market scene since June, 1963. Instead, stocks run up, then decline; others explode on the upside while others collapse. The net result is a profitless "bull swing", as suggested by the relationship of the A-D ratio and the Industrial Average on page 1. This type of "three winners— three losers" action has continued for almost a year. Is it any wonder that traders and investors are now frustrated? Is it any wonder that the public refuses to come in "with both feet"? Is it any wonder that Time, Newsweek, and other national magazines no longer sing the praises of the stock market?

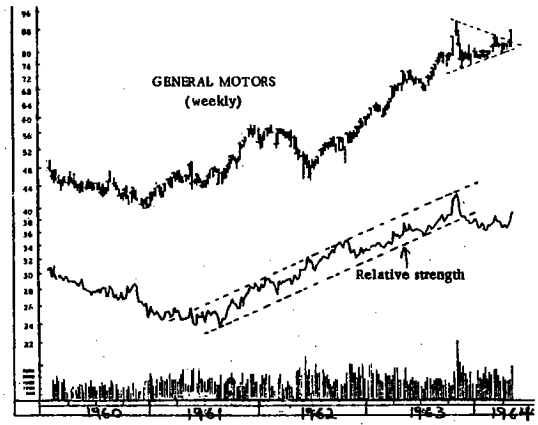
Conclusion: be patient. Your chances of showing profits over the past year have been no better than your chances of showing losses. The billionaire, Jean Paul Getty was asked for the secret of his success. His answer was that he never went into a venture unless the odds were definitely on his side. I have always felt the same way about the market. The trend of the A-D ratio measures your odds — study it!

STOCKS: Of 432 stocks which are carefully checked here each week, 309 or 70% are currently holding above their 200-day (long-term) moving averages. This represents no change from last week, but as seen on the accompanying chart, the main upward trend in the bullish percentage has now been broken. The probability of a decline in the bullish percentage would now seem strong, but again — as long as the percentage holds above 50% this study will remain bullish.



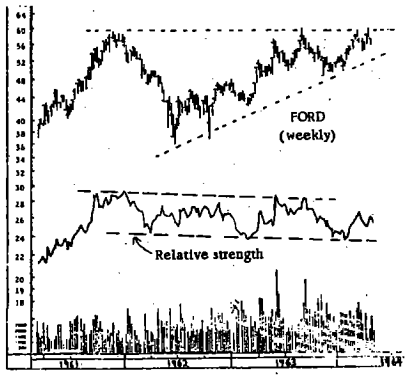


The "big three" motor stocks undoubtedly comprise the most interesting and significant technical problems on the board. As commented upon recently, GM (which now has every technician in the nation scrutinizing its chart with a magnifying glass) broke under its rising relative strength (R. S.) channel in late-1963 (see chart). The stock then formed a large symmetrical triangle — a pattern of "indecision" (Letter 251). Over the past few weeks GM has pushed out of the triangle to the upside. Although this is a bullish breakout, I noted that a breakout which occurs near the apex (tip) of a triangle generally lacks force. As of this writing, we do not know whether GM is going to form a "double top" in the 89-91 area or rise to a significant new high. Only the passage of time will tell us this. But the amazing thing is that both Chrysler and Ford are also in position to form either "multiple top patterns" or to break out importantly to the upside. What these stocks do now will affect the whole market.



Of the three motor patterns, Chrysler's is the most complex. Following its giant 1962-64 rise, C has traced what appears to be a "head-and-shoulders bottom" (A, B, C on chart). But such a pattern (i.e., a bottom pattern) is suspect when it occurs on top of a rise (conversely, a top pattern is suspect when it appears after a major decline). Adding to the Chrysler problem, the "right shoulder" has taken the form of a "flat-bottom broadening pattern" (1, 2, 3, 4, 5 on chart). Thus, point 5 has lifted C to an all-time high, but if the new high is actually the peak of a broadening formation, it could be less bullish than most observers believe. The final resolution of the C pattern should occur shortly.

Lastly, giving Ford the benefit of the doubt, one might say that it has formed a huge "ascending triangle". But in view of the other motor patterns, one cannot dismiss the possibility of a "triple top" in Ford. That possibility is heightened because of Ford's declining R. S. trend.



Finally, we must ask ourselves what type of buying might occur following a virtual torrent of good news from the auto industry. Professionals would certainly hesitate to buy these stocks after the news (but, of course, bulls on the motors can claim that even rosier auto news is ahead — and the stocks are therefore still worth buying).

Although in many cases defence stock earnings are good, the market seems to be discounting a famine ahead. These stocks should be sold and avoided. Such issues as Avco, Litton, Northrop, Douglas, Gen. Dynamics, Martin, and even GE and Westinghouse appear either "toppy" or in the process of topping out. Litton and Avco (see charts) should be good shorts on a rally.

There is reason to believe (Letter 251) that the majority of Cement stocks have concluded or are near concluding a major bear market. Gen. Portland and Penn-Dixie have both turned up in R. S. and appear to be heading higher.

Charts of the motor stocks courtesy of Traders Research, 1431 Pearl Avenue, Alton, Illinois 62003.
Charts at bottom of page 4 courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas.